

other natural deposits, and timber that there shall be allowed as a deduction a reasonable allowance for depreciation of improvements. Such allowance shall include exhaustion, wear and tear, and obsolescence. The deduction allowed under section 611 shall be determined under the provisions of section 167 and the regulations thereunder. For purposes of section 167 the unit of production method may, under appropriate circumstances, be considered a reasonable method under section 167(a), and therefore, not subject to the limitations prescribed by section 167(b).

(b) *Special rules for mines, oil and gas wells, other natural deposits and timber.* (1) For principles governing the apportioning of depreciation allowances under sections 611 and 167 in the case of property held by one person for life with remainder to another or in the case of property held in trust or by an estate, see § 1.167(h)-1.

(2) A reasonable allowance for depreciation on account of obsolescence or decay shall be required in an appropriate case during periods when the improvement is not used in production or is used in producing at a rate below its normal capacity. This rule is applicable whether or not the taxpayer uses the unit of production method.

(3) See sections 615 and 616 and the regulations thereunder for special rules for treatment of allowances for depreciation of improvements with respect to the exploration and development of a mine or other natural deposit (other than oil or gas).

(4) In the case of operating oil or gas properties, the deduction for depreciation shall be allowed for those costs of improvements such as machinery, tools, equipment, pipes, and other similar items and the costs of installation which are not treated as a deductible expense under section 263(c). See § 1.612-4.

(c) *Accounting and recordkeeping.* See § 1.167(a)-7 for accounting and recordkeeping requirements for taxpayers claiming deductions under section 611 and this section.

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**§ 1.612-1 Basis for allowance of cost depletion.**

(a) *In general.* The basis upon which the deduction for cost depletion under section 611 is to be allowed in respect of any mineral or timber property is the adjusted basis provided in section 1011 for the purpose of determining gain upon the sale or other disposition of such property except as provided in paragraph (b) of this section. The adjusted basis of such property is the cost or other basis determined under section 1012, relating to the basis of property, adjusted as provided in section 1016, relating to adjustments to basis, and the regulations under such sections. In the case of the sale of a part of such property, the unrecovered basis thereof shall be allocated to the part sold and the part retained.

(b) *Special rules.* (1) The basis for cost depletion of mineral or timber property does not include:

(i) Amounts recoverable through depreciation deductions, through deferred expenses, and through deductions other than depletion, and

(ii) The residual value of land and improvements at the end of operations

In the case of any mineral property the basis for cost depletion does not include amounts representing the cost or value of land for purposes other than mineral production. Furthermore, in the case of certain mineral properties, such basis does not include exploration or development expenditures which are treated under section 615(b) or 616(b) as deferred expenses to be taken into account as deductions on a ratable basis as the units of minerals benefited thereby are produced and sold. However, there shall be included in the basis for cost depletion of oil and gas property the amounts of capitalized drilling and development costs which, as provided in § 1.612-4, are recoverable through depletion deductions. In the case of timber property, the basis for cost depletion does not include amounts representing the cost or value of land.

(2) Where a taxpayer elects to treat the cutting of timber as a sale or exchange of such timber, the basis for cost depletion shall be the fair market value of such timber as of the first day

of the taxable year in which such timber is cut and such value shall be considered for such taxable year and all subsequent taxable years as the cost of such timber for all purposes for which such cost is a necessary factor. See section 631(a).

(c) *Cross references.* In cases where the valuation, revaluation, or mineral content of deposits is a factor, see paragraphs (c), (d), (e), and (f) of § 1.611-2. In cases where the valuation, revaluation, or quantity of timber is a factor, see paragraphs (e), (f), and (g) of § 1.611-3. For definitions of the terms *property*, *fair market value*, *mineral enterprise*, *mineral deposit*, and *minerals*, see paragraph (d) of § 1.611-1. For rules with respect to treatment of depletion accounts on taxpayers' books, see paragraph (b) of § 1.611-2 in the case of mineral property, and paragraph (c) of § 1.611-3 in the case of timber property.

#### § 1.612-2 Allowable capital additions in case of mines.

(a) *In general.* Expenditures for improvements and for replacements, not including expenditures for ordinary and necessary maintenance and repairs, shall ordinarily be charged to capital account recoverable through depreciation deductions. Expenditures for equipment (including its installation and housing) and for replacements thereof, which are necessary to maintain the normal output solely because of the recession of the working faces of the mine and which:

- (1) Do not increase the value of the mine, or
- (2) Do not decrease the cost of production of mineral units, or
- (3) Do not represent an amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made shall be deducted as ordinary and necessary business expenses.

(b) *Special rule.* For special provisions applicable to treatment of expenditures for certain exploration and development costs (other than for the acquisition, restoration, or betterment of improvements) with respect to minerals other than oil or gas, see sections 615 and 616 and the regulations thereunder.

#### § 1.612-3 Depletion; treatment of bonus and advanced royalty.

(a) *Bonus.* (1) If a bonus in addition to royalties is received upon the grant of an economic interest in a mineral deposit, or standing timber, there shall be allowed to the payee as a cost depletion deduction in respect of the bonus an amount equal to that proportion of his basis for depletion as provided in section 612 and § 1.612-1 which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the payee's basis for depletion and the remainder of the basis is recoverable through depletion deductions as the royalties are thereafter received. (But see paragraph (e) of this section.) For example, a taxpayer leases mineral property to another reserving a one-eighth royalty and in addition receives a bonus of \$10,000. Assuming that the taxpayer's basis with respect to the mineral property is \$21,000 and that the royalties expected to be received are estimated to total \$20,000, the depletion on the bonus would be \$7,000:

$$[\$21,000 \text{ (basis)} \times \$10,000 \text{ (bonus)}] \div \$30,000 \text{ (bonus plus estimated royalties)}.$$

The remaining \$14,000 of basis will be recovered through depletion as the royalties are received.

(2) If the grant of an economic interest in a mineral deposit or standing timber with respect to which a bonus was received expires, terminates, or is abandoned before there has been any income derived from the extraction of mineral or cutting of timber, the payee shall adjust his capital account by restoring thereto the depletion deduction taken on the bonus and a corresponding amount must be returned as income in the year of such expiration, termination, or abandonment.

(3) In the case of the payor, payment of the bonus constitutes a capital investment made for the acquisition of an economic interest in a mineral deposit or standing timber recoverable through the depletion allowance. See paragraph (c)(5)(ii) of § 1.613-2 in cases in which percentage depletion is used.

(b) *Advanced royalties.* (1) If the owner of an operating interest in a mineral deposit or standing timber is required